

Contemporary Challenges Confronting Islamic Banking & Finance

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ABSTRACT. The philosophy of Islamic economics is “brining economics in consonance with Shariah”, guiding Islamic banking and finance to abolish interest from operations, has reported a monumental growth, envisaged the most lucrative and unsuseptible segment of the economy. Islamic finance is undoubtedly flourishing worldwide entail trajectory development but at other front it encounters a number of impediments in development since its inception. The emphasis of this study is to encapsulate in tabular form, the contemporary problems and challenges Islamic finance has encountered during the span of last 28-years from 1988 to 2015. The austere Shariah compliance; regulatory and prudential challenges; misconception among western society about Islamic banking philosophy; unavailability of money and capital market for scant Islamic financial instruments; piercing competition; privation of Islamic banking and finance awareness; absence of uniform reporting standards; complexities of regulatory and supervisory issues; lack of central supervisory body, governance and dearth of consensus among *Shariah* scholars been the precarious challenges among many others. A unified central regulatory and supervisory mechanism required in converging sprinkled Islamic finance practices and to foster a synchronized and standardized regulatory network consensus need to be developed among all *Shariah* scholars.

1. INTRODUCTION

The philosophy of Islamic economics is “brining economics in consonance with Shariah” guiding Islamic banking and finance to abolish interest from operations, has reported a monumental growth, it envisaged the most lucrative and unsuseptible segment of the economy. Islamic banking emerged in 1963 in Egypt, currently operating successfully in above sixty countries with more than 300 financial institutions offering wired range of Islamic products and services. Nascent Islamic banking and finance has become a substantial challenge to firmly rooted western counterpart.

“Islamic finance is becoming an integral part of the global finance industry and has taken its roots in almost all of the Muslim countries but has also been under discussion and penetration in selective Western and Far Eastern jurisdictions”

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Starting with modest beginnings nearly four decades ago, global Islamic finance has witnessed significant progress attracting both Muslims and non-Muslims clientele. With Middle East and Asia being the largest Islamic financial markets, many developed non-Muslim countries including USA, U.K, Korea, Luxembourg, Singapore and China are gradually recognizing Islamic finance as an alternate and viable financial system. Recent reports suggest that global Islamic banking assets are set to cross US\$1.8 trillion in 2013⁴.

Products offered by Islamic financial institutions range from commercial and investment banking, to *takaful*, mutual funds and capital markets. *Sukuk* in particular has proved to be a powerful tool in building the confidence of international investors in Islamic finance and has become an important tool for fulfilling public and private sector financing needs in a Shariah compliant manner. Moreover, there are dedicated regulatory, accountings, Shariah and academic institutions at the global level that are providing support in establishing sound foundation for the Islamic Financial System. The significant growth of Islamic finance is reflective of increasing acceptability of its merits and it is advancing towards globalization (SBP, 2013).

Objective of the study

Islamic finance is undoubtedly flourishing worldwide entails trajectory development but at other front it encounters a number of impediments in development since inception. The emphasis of this study is to encapsulate the contemporary problems and challenges Islamic finance has encountered during the span of last 28 years from 1985 to 2015.

2. KEY PROBLEMS AND CHALLENGES

This section accounts for the scholarly contribution pertaining to key problems and challenges encountered by Islamic banking and finance over last 28 years.

Unavailability of expertise pertaining to long term financing, lack of back-up institutional structures such as secondary capital markets for Islamic financial instruments and strict compliance with the Shariah rule were the major confronting issues to Islamic financial system (Ariff, 1988). The idea of Islamic economy is quite viable but some critical factors in implementing at large scale are inadequate institutional arrangements, lack of effective leadership and organization, intellectual resources mobilization through centers for learning (Siddiqi, 1989). Loss of Opportunities, Sharia Law's Admissibility in International Courts, Manpower Shortage, Undeveloped Interbank and Financial Markets, Lack of Unified Accounting Standards for Islamic Banking are the key weaknesses, handicaps and problems faced by Islamic banks (Pervez, 1990).

Muslim economists need to change their focus. Instead of developing a theory in the framework of an ideal Islamic society, they should choose a contemporary economy and show, on the basis of real-life data, that the primary cause of existing economic problems lies in deviation from the Islamic principles of economic management. The economics that can grow with valid assumptions, adequate methodology and a body of economic theory capable of ushering in a humane society, would be the economics of the future (Khan, 1991). How to finance growth opportunities of a sole proprietorship *Mudarabah*, *Musharaka* or a hybrid enterprise? This question will remain as an important concern in Islamic finance Islamic finance confronts the challenge to devise Islamic financial instruments which can enable firms, sole proprietors in particular, to finance their growth without compromising on their ownership structures. In this regard, in addition to ownership sensitivities, retention and re-investment of profits is also worth mentioning (Ghazali, 1992).

⁴ Ernst & Young's World Islamic Banking Competitiveness Report 2013.

The problem that Muslim countries face is even more difficult than that faced by the industrial countries; resources at their disposal are even scarcer. Removal of their macroeconomic and external imbalances requires a reduction in aggregate demand. Realization of the *maqaid* requires the opposite of this: increased spending for a number of neglected but essential objectives. How to resolve this conflict is the challenge that Muslim countries face. They cannot respond to this challenge successfully by adopting strategies that have failed. A failed strategy cannot but lead to failure. What the Muslim countries need to do is to develop their own strategy - one that will help them allocate scarce resources efficiently and equitably in accordance with the demands of *Shariah* (Kuran, 1993). The study identified the following theoretical issues in Islamic banking: Examination of the permissibility of credit creation by banks from the *Shariah* point of view, Seigniorage (i.e., profits of money creation, its entitlement and distribution, Risk and expectational characteristics of households, firms and banks in an interest free economy, Ways of introducing negotiable papers in the Islamic financial market and the ways of controlling "hot money" movements in an Islamic framework of money and banking (Siddiqui, 1995).

Social justice and equitable distribution of wealth and taxes, monopoly, illegitimate ownership, abolition of interest completely are among the macro challenges to Islamic economy and financial system but there is a need to remove the misgivings from western community's mind regarding Islamic economics (Bin Sayeed, 1995). Islam has a very specific approach to commercial transactions, the law of contract, interest charges, linked to the very nature of property; this poses a variety of problems for Islamic banks. Work within different economic, financial, social, legal and religious environments, complex Islamic concepts of banking, how impact upon the use of financial instruments, commercial priorities and services, relationships with central banks, comparative analysis of financial statements and the role of Islamic banking in a development context are the serious issues (Al-Omar, Ahmad Haq & Fuad al-Umar, 1996).

Findings establish that, in Singapore, which has a minority of Muslims in its population, both Muslims and non-Muslims are generally unaware of the culture of Islamic banking. Also the two separate groups have different attitudes towards the Islamic banking movement, with the degree of difference depending on the nature of the respective matter put to them (Gerrard & Cunningham, 1997). Building a proper institutional set-up, increased competition, building bridges and strategic alliance, need to increase the size of Islamic banks, financial engineering, *Shariah* aspects, teaching, training, research and development, fixed versus variable modes of finance, establishment of equity instruments, appropriate legal framework, policies and procedures and supervisory framework are perhaps the most serious challenges to Islamic finance (Iqbal, Ahmad & Khan, 1998).

The challenge to implementing market based monetary policy in Islamic banking system. Islamic banking system, *Shariah* compatible money market instruments, suitable for monetary and government debt operations, has continued to remain a key challenge for Islamic Finance. The absence of Islamic money markets continues to raise the liquidity risks of Islamic banks and weaken their profitability (Marston, Shabsigh & Sundararajan, 1998). Islamic financial system is to become truly liquid and efficient it must develop more standardized and universally tradable financial instruments, the development of a secondary financial market for Islamic financial products, develop more transparency in financial reporting and accounting and ideally a form of Islamic GAAP, development of inter-bank and money markets (Sarker, 1999).

Technology is another challenge as Islamic banks are competing in a highly developed technological market that utilizes a wide range of sophisticated banking products. The problem is not only in the adoption of technology but in the preparation of a suitable environment that will enable them to utilize the technology in order to compete effectively. The globalization also imposes a challenge on the *Shariah* authorities in Islamic banks in the issuing of *Fatawah* required

in the rapidly evolving international financial markets (Al-Raji, 1999). Regulatory complexities and branding of Islamic products are two prominent issues confronting Islamic financial institution in West and UK (Wilson, 1999).

Notwithstanding of Sharia compliance monetary policy for Islamic banks. Regulations for interest-based banking is equally applicable for the Islamic banks as in case of overdrawn funds from central bank interest required to be paid. No separate regulatory and supervisory guidelines for the Islamic banks. There are no Islamic financial Instruments developed for the Islamic banks to accommodate their excess liquidity or to provide them a new avenue for short term investment (Sarkar, 2000). A number of factors to be considered while confronting with conventional banking sector and an effective Islamic system facing the challenges like lack of financial markets in which Islamic financial instruments can be traded. The growth is closely tied with the nature of novelty in the Islamic products and individual will choose these products according to their commercial needs as well as religious philosophy (Zaheer & Hassan, 2001).

The provision and use of financial services and products that conform to Islamic religious principles pose special challenges for the identification, measurement, monitoring, and control of underlying risks. Effective and efficient risk management in Islamic financial institutions has assumed particular importance as they endeavour to cope with the challenge of globalization. This requires the development of not only a more suitable regulatory framework, but also new financial instruments and institutional arrangements to provide an enabling operational environment for Islamic finance (Sundararajan & Errico, 2002). The role of the state needs to be limited to that of a facilitator in matters of financial services. In particular, it needs to constantly monitor and upgrade the legal and regulatory environment in which the industry operates without stifling independent initiatives or disorienting it through abrupt, poorly transparent changes. The state needs to refrain from becoming directly or indirectly the promoter of financial activities where its presence is not essential for the public good. Similarly, the population and businesses need to refrain from looking at the state as the benevolent father, supplier of applause for success, and compensation for failure (Grais & Ventur, 2003).

Several challenges to Islamic banks relating to instruments, financial markets, regulations, clarity of its concepts and its awareness must be addressed and a viable solution must be found which is hindering the progress of Islamic banks. Perhaps the most problematic aspect is the image and perception of Islamic financial institutions in the global market (Nasim, 2003). It is apparent that the experience of previously established Islamic institutions, such as Al-Baraka, has made other institutions realize that it is possible to provide Islamic banking services in the UK under nonbanking regulations. The interviews also revealed that the main problem that Islamic banking faces in the UK is heterogeneous clients and potential clients. Moreover, regulatory hurdles, competition from conventional banks, and lack of adequately qualified and trained personnel exacerbate the situation (Karbhari, Naser & Shahin, 2004). Fatwa is basically a religious ruling on a matter of Islamic laws not clearly mentioned in Shariah. Fatwa is required on those matters which are uncertain in Islamic banking activities and are not in line with Shariah (Ali, 2005).

Serious challenge confronting to Islamic banking practitioners is an unresolved *fiqh* issue? A failure to realize *maqasid* al Shariah in a changing environment? In any case it requires stepping out of the current framework of thinking to face new realities and accommodate new priorities. Even from within the known techniques, there are some like mutuality whose potential for meeting this challenge has yet to be fully discussed and tried (Siddiqui, 2006). Risk management is one and at other front challenge concerns the diversity of opinion among Sharia scholars as to whether particular practices or products are Sharia-compliant. On a global level too, the

ratification of Islamic firms' products and services may depend on the jurisdiction in which they are offered. This can add another layer of complications for regulators (Briault, 2007).

One important issue is that there is not a well-organized connectivity and network among Islamic FIs around the world and products offered are not homogenous. Such impediments may be removed to enlarge the processes and marketing strategies should be reframed to gauge international customers (Garas & Manama, 2007). Regulatory amendments regarding structure of Islamic investment and financing and liquidity risk management. Lack of efficient and transparent capital markets, short-term Islamic money market, Islamic instruments, Islamic Financial Reporting Standards (IFRS), appropriate legal frameworks and regulatory disparity among national supervisors (Hesse, Jobst & Sole, 2008). Lacking broad popular demand, lack regulatory support by the state and lack experience in microfinance, Islamic rural banks, mostly under absentee ownership; have failed to prove themselves as efficient and dynamic providers of microfinance services (Seibel, 2008).

Key issues facing Shariah compliant banks trying to grow their liquidity management products suite: Limited Islamic secondary markets, Various Shariah interpretations, Small number of participants, Slow or stagnant development of Islamic financial instruments, Commodities and inventory risk, Legal and Shariah compliance risk, Equity position risk, Mark-to-market risk and Transfer risk (SunGard, 2008). The results of the research have led to the conclusion that besides other problems inadequate telecommunication infrastructure has been found the major problem in proper IT implementation in the Pakistani organization (Shaukat, Zafarullah & Wajid, 2009).

Misconception against Islamic Banking, Lack of uniformity between Shariah's view, Documentary complexity, moving towards equity-based financing, Heightened Competition and Brand Recognition are serious issues facing Islamic banking (Samat, 2009). The challenges facing the regulators and supervisors of Islamic banking are: Lack of standard practices and different interpretation of same issue by Shariah board of each bank; market discipline and transparency and corporate governance issues (Ahmed, 2010). The emerging institutions offering Islamic banking services; however is creating a challenge to regulatory and supervisory bodies as this challenge is different from others. This distinct challenge arises because of the methods these institutions adopt to mobilize funds and to deploy them to earn income on them. Among these assets management, Islamic banking contracts, protection of Islamic banks customers, transparency and professional competition are prominent (Khan & Porzio, 2010).

Liquidity risk is one of the major challenges for Islamic banks in Pakistan and this study found insignificant but positive relationship of the networking capital ratio and bank size to LRM (liquidity risk management) and significant and positive association of CAR in conventional banks and POA in Islamic banks at 10 percent level (Sadaqat, Ali & Farhan, 2011). There are three enormous challenges to the Islamic banks; 1) Compliance to Sharia while operating among the conventional banking sector that has captured the maximum portion of market share by its organized and wider network, 2) to cater the increasing need of industrial and business sector, and 3) to counter the embedded perception of Muslims that Islamic banking system is merely duplication of Interest-based system under the shade of Sharia (Hanif, 2011).

Islamic banking Industry is in need of transforming regulatory framework, risk and retail banking, so, the operations can be optimized and integrated with technology and mitigation of risk may be made possible (Ernst & Young, 2012). There is no single authority that governs Islamic financial industry. There is no harmony among the Shariah scholars who give ruling about Islamic financial products. All the Islamic banks have their own Shariah Supervisory Board (SSB) who has knowledge of both finance and religion (Shah, Raza & Khurshid, 2012). Stiff competition with deep rooted conventional banks and the promotion of distributional and allocating efficiency

from all dimensions together with profitability are more challenging for Islamic banks in Bangladesh (Ullah & Chowdhury, 2013).

To compete on a level playing field with other financial institutions, Islamic banks would need to be competitive and this means producing and having more innovative products that meet the demands of the individual and businesses. The Islamic products developed must comply not only with Shariah requirements but also with the country's legislation, guidelines and circulars. Corporate governance, supervision and monitoring the operations and performance of the Islamic banks are crucial in ensuring that banks carry the role to serve their client the Shariah way. Without proper regulations, policies and enforcement, the implication is normally transferred to the consumer (Aris, Othman, Azli, Sahri, Razak & Rahman, 2013).

Although industry represents remarkable performance and liquidity management, it has some challenges to be solved. Among others, there are three main challenges. The first challenges is the market share of the industry which was 4.2 percent at the end of September, 2012 and lack of human resource and lack of product development are two other hindering the expansion of industry (Ismail, 2013). The Shariah compliance is the backbone of IFIs ensuring their integrity and credibility. The existence of non-compliance element will not only affect the confidence level of IFI's shareholders and public but in addition to Shariah non-compliance risk and associated reputational risk may also expose IFIs to various other losses (Karim & Archer, 2013).

Lack of determination at the senior executives and managers, Lack of clear rules and adequate supervision, Lack of competitiveness with conventional banking system, Investors' risk aversion and the desire to get a fixed profit and Lack of sufficient awareness among customers and people are significant challenges among others (Seyed-Jalil Kaei, Safari & Iravani, 2014).

The religious challenges found in this study are of two categories: Those that emanate from non-Muslim believers on one hand and that which are from within the boundaries of Islam on another hand. When non-Muslims misperceived the institution to be battling against their religious dogmas, some Muslims also misperceived it to be similar to the interest based system i.e. (not in line with the actual teachings of the Quran and Sunnah). The mentioned challenges are regarded religious because of their direct linkage with religious belief (Yunusa & Nordin, 2015).

3. CONCLUSION

The monograph has contrived comprehensively the contemporary problems and challenges being faced by Islamic finance during last twenty eight years (1988-2015). The austere Shariah compliance, regulatory and prudential challenges; misconception among western society about Islamic banking philosophy; unavailability of money and capital market for scant Islamic financial instruments; fierce competition; privation of Islamic banking and finance awareness; absence of uniform reporting standards; complexities of regulatory and supervisory issues; lack of central supervisory body, governance; dearth of consensus among *Shariah* scholars; Lack of determination at the senior executives and managers; Lack of clear rules and adequate supervision; Lack of competitiveness with conventional banking system and misperception against the religious dogmas been the precarious challenges among many others.

4. RECOMMENDATIONS

Islamic banking and finance has a promising future hence, aforementioned issues mandate policy makers an objective religious zeal to grapple them. A unified central regulatory and supervisory mechanism required in converging sprinkled Islamic finance practices and to foster a synchronized and standardized regulatory framework consensus need to be developed among all *Shariah* scholars.

5. LIMITATIONS AND FUTURE RESEARCH

The fundamental objective of this study was to highlight the contemporary challenges and problems Islamic banking and finance has been facing during 1988-2015. What would be the optimal mechanism to tackle the highlighted challenges and issues could be a prodigious extension to the study.

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